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# Global Equity Outlook– at the brink of the 2020's

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My love and passion for listed stocks is as strong as ever.

Not just now because listed equities are relatively cheap compared to the alternatives. Even after more than a decade of rising stock markets, you still get a solid coupon on select unique stocks, such as the current 2.5% – with a steadily growing dividend yield in Swiss francs – as an owner of the "mother of all stocks" Nestlé. This compares to a 'safe' loss of 1% on a Swiss 10-year bond.

And not just because you can benefit from carefully chosen companies growing bigger over time and follow their progress in detail.

But, also because you can influence companies through active ownership by voting and engaging. What a fantastic and timeless vehicle for investing.

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## Will the love persist in a downturn?

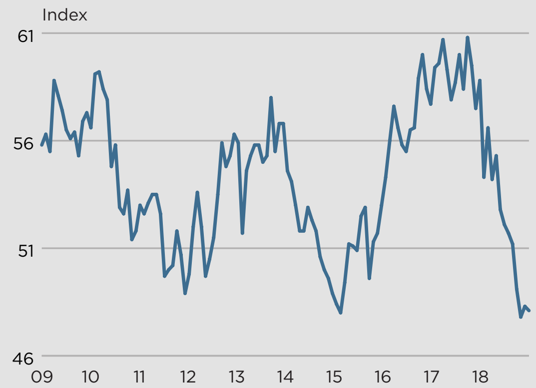
It is easier to declare your endless love for stocks in good times compared to bad times. And times have been good for many years. Now, like at most year-ends, it is typical for so-called experts to share their optimistic expectations about stock markets for the future. Actually, the experts are generally right as stock markets go up during most years and continue to compound with equities being a potent symbol of the triumph of the optimists. In modern times, equities primarily only run into real trouble when faced with a US recession. The recession risk is being discussed constantly, but modern history shows it only happens about once a decade which, in turn, provokes a massive response from central banks and governments to prevent it from lasting for too long.

> **Looking into 2020, the most likely scenario is a continuation of the already extended economic cycle but with a pick-up in the industrial part of the economy.**

We live in the most politically controlled environment in decades as debt burdened central authorities around the world control the most important price of all – interest rates. In times of future trouble, we will get the next wave of unconventional monetary and fiscal policy initiatives. That can and will continue until the disappearance of trust in central authorities and the disappearance of trust in money as we know it. Many doomsday pessimists have made it a business to predict such an outcome, but I would not advise you to hold your breath while waiting for that scenario to unfold.

Looking into 2020, the most likely scenario is a continuation of the already extended economic cycle but with a pick-up in the industrial part of the economy. For the first time in a decade, we see coordinated expansive monetary and fiscal policies across the world as politicians worry about a setback after the third mini-recession of the decade as shown in figure 1.

**Figure 1:**
Global Composite PMI




Source: Bloomberg as of Dec. 2019

At this stage we have had a negative recessionary signal from one of the most powerful indicators of all time – an inversion of the US yield curve. Hence, we find it prudent to highlight three risk scenarios that shorter-term investors should be aware of.

Policy choices are playing a key role and the extreme central bank policy decisions are keeping the macro and stock market cycle going. Some label this as a 'policy bubble peak'.

1) **The policy bubble peak**
   A surprise reversal of the loose central bank policy would create trouble for markets. This scenario has a low risk of happening in the short term as debt levels to GDP are very high, making governments a big loser if the cost of debt were to rise. The other side of debt is big asset markets as a share of the global economy - the financial economy. The world has become addicted to high asset prices. It is hard to see a reversal, unless it is linked to a long-term increase in inflation expectations and in long-term economic growth prospects.

2) **The US election surprise**
   A change in the US presidency to Elizabeth Warren or Bernie Sanders would create fundamental underlying business uncertainty and a possible downturn in markets.

3) **The Silicon Curtain risk**
   Despite a friendly world gathering around the Summer Olympics in Japan in 2020, the rise of nationalism is set to continue. Indeed, this theme is gaining momentum. Politicians are elected on a national level and increased government spending will be domestically focused in a world that is skeptical about the effects of globalization after the financial crisis. Confrontation not just between the US and China about global technological leadership, but also an overall escalation of trade conflicts and breakdown in international organs like the WTO is a potential problem for markets. Not just because it directly reduces trade, but also as it increases uncertainty and pessimism.

Even then to be clear, if a downturn were to happen, my fundamental passion for equities – especially the few truly unique stocks - would persist. Especially if we are going Japanese!

## Going Japanese

Japan is one step ahead in living in an aging society. The country is an interesting laboratory for investors to investigate as it gives a peek into what the future might look like for many other important developed economies. Japanese prime minister Abe just launched another record fiscal stimulus package to support the economy. Japan has reached the next stage of monetary policy by having an explicit target on the 10-year bond yield of 0%. Even if it seems that the BOJ has paused its buying of late, the Japanese central bank has a policy of buying equities directly in the market at a rate that it is said to be at USD 55 billion a year since 2016, and it has been a significant buyer every time the market falls more than 0.5%. It is very hard to drive growth in an aging society despite the undisputed qualities and extreme work ethic in the Japanese economy.

I think we need to go full circle in the western world, and this means going through this Japanese exercise – and even further beyond – before we get a paradigm shift in policy thinking. Direct funding of public investment projects and interest rate targeting by central banks, as well as stock purchasing is coming to a country near you – and could become the norm in larger parts of the world.

Based on the Japanese experience, slow economic growth is the likely scenario – see figure 2. Japan has had periods of economic growth around zero and close to full employment. A recession – stagnation – is not such a big thing in Japan. Maybe that is a new normal for most of the world?

**Figure 2:**
Economic Development (GDP) in Japan


Source: Bloomberg as of Dec. 2019

Something has changed in the world of economic cycles. There is less volatility in an economic world that has moved from goods to services. Inflation expectations have been anchored at low levels, and we now live in what can be labelled the "financial world economy." It is the tail wagging the dog – the swings in the financial world (interest rates) that drive changes in the real economy and especially with monetary policy driving the financial world, the circle is complete.

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If the next decade is a slow growth decade, where we hover around 1-2% GDP growth in developed economies such as Japan, we will stay in a long-term low interest environment. A series of soft upturns and downturns – boring, but good. Such a scenario will benefit a select portfolio of sustainable growth stocks – like we have seen in Japan.

## Listed equities – still compounding potential – and a melt-up?

In many developed countries you are now PAYING for the 'privilege' of having money in your bank account.

A large portion of investors who lend out money to governments via buying government bonds also have to pay for that privilege.

The classic balanced portfolio with a core of compounding low risk bonds is compounding no more. But right now, it is as if the stock market can't believe that compounding in big parts of a closely related asset class is dead.

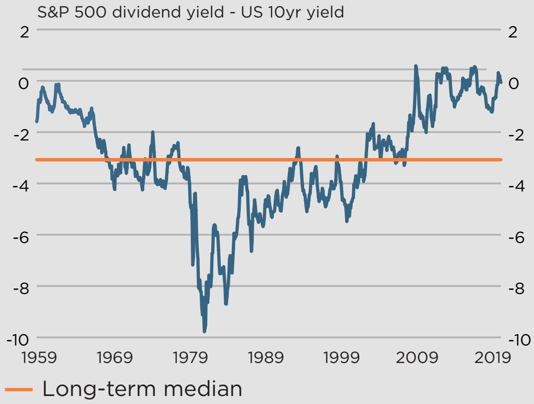
The stock market cannot believe that for the first time in thousands of years, the principle of giving-up something valuable for a longer period doesn't give you a reward. For example, if I was a farmer five thousand years ago, and I was lending-out seeds of corn to my neighbour, I would get more seeds or seed equivalents back next year. That fundamental principle has now been broken with central banks going below zero, dragging world interest rates down and a broad range of assets up. The bond and interest rate markets are at such extremes and the equity markets haven't really discounted it yet. Going back to the previous example, Nestlé is generating a dividend yield of 2.5% and a free CF yield of 4% with an expected growth rate of 4%. At unchanged valuations, Nestlé is an asset that should generate an annual return of 8%. Compare that to the Swiss 10-year bond yield of -1%, and this provides an equity risk premium of 9%.

Even if Nestlé doubled in stock price and then became a 2% free CF yield stock, the FCF yield plus the growth rate of 4% would still compare very well with the -1% of the Swiss bond, resulting in a risk premium of 7%! This illustrates the potential and the significant bull market that could be ahead of us, if markets actually really started discounting and believing in low rates forever. A true melt-up!

It is quite often the case that the more naturally skeptical bond markets get it first, and then the ever optimistic equity markets follow and come to the same realization. The bond markets are giving you a clear signal – no inflation and low interest rates for years to come. And as highlighted above, bond markets might be right.

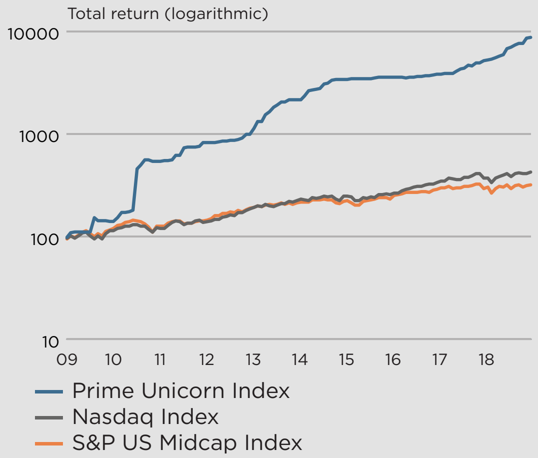
But as seen in this graph, public equity markets are not pricing this in yet. In the US, where interest rates are still above zero, the dividend yield is now solidly above the 10-year bond yield – pointing to a relatively cheap stock market as depicted in figure 3.

**Figure 3:**
Yield difference




Source: Bloomberg as of Dec. 2019

**Figure 4:**
Divergence between private and public equities




Source: Bloomberg as of Oct. 2019

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## Where is the bubble?

Flow of funds have gone less in the direction of listed equities and more in the direction of alternatives. The unlisted equity space reflects the big flows that have gone into private equity. The valuations of the unicorns in figure 4 have not been subject to public market analysis and valuation. Nevertheless, it is still fascinating to see how the Unicorn index has performed over the last decade in comparison with public market indices.

This could be an area of greater investment risk. The bet is that when the real unicorn stands out, it will generate so much return that you can afford to have the losers as well. The question is if you are in the right fund with the great company pickers or in an average fund that will have a hard time fulfilling these grand expectations.

## Five moments in equity market history

As a mindful and long-term oriented investor, selecting the right assets and the right individual stocks is as relevant as ever.

Without going into a discussion about Kuhn's concept of paradigm shifts – essentially shifts of revolutionary nature in common thinking about a certain issue – the power of paradigm shifts reveal themselves when looking back at dominating beliefs in financial markets at the beginning of a new decade over the last 40 year period. So, let us take a quick tour in financial market history to see if we can learn something from this and also something about investing overall that maybe useful for the coming decade.

**Figure 5:**

**The decade's top 7 stocks by market cap seldom make it to the end of the next decade**

| 1980 | 1990 | 2000 | 2010 | 2019 - December |
|---|---|---|---|---|
| IBM | NTT | Microsoft | Exxon Mobil | Saudi Arabian Oil Co. |
| AT&T | Bank of Tokyo-Mitsubishi* | General Electric | PetroChina | Apple Inc. |
| Exxon | Industrial Bank of Japan | NTT DoCoMo | Apple Inc. | Microsoft |
| Standard Oil | Sumitomo Mitsui Banking | Cisco Systems | BHP Billiton | Google |
| Schlumberger | Toyota Motor | Wal-Mart | Microsoft | Amazon |
| Royal Dutch | Fuji Bank | Intel | ICBC | Facebook |
| Mobil | Dai-Ichi Kangyo Bank | NTT | Petrobras | Alibaba |

*Merged entities

Source: Gavekal as of December 2019

## 1980’s

Back in 1980, when US interest rates were 10%+ and going higher, we lived in an inflationary environment where inflation was deeply ingrained in the thinking of people and financial markets. 6 of the 10 biggest companies in the world at the time were oil companies with Exxon, Standard Oil and Royal Dutch being on the list, and the list was dominated by US companies. Commodity cycles are cyclical in nature and high prices lead to a supply response. This was another commodity stock peak that did not prove to be long-lasting.

## 1990’s

A decade later, at the outset of the 1990’s, only Exxon was left on the list of the 10 biggest companies by market cap in the world. 8 out of the 10 largest were Japanese and 6 of them were Japanese banks such as Fuji Bank and Industrial Bank of Japan. I can personally attest that the common thinking at the time, when I started my career in 1989, was that Japan Inc. would take over the world. It also became clear to many that the massive real estate and debt bubble in Japan was unsustainable. The paradigm shift faded and there was not a single Japanese bank on the list by 2000.

## 2000’s

As many will remember, 2000 was the peak of the internet and telecommunications bubble with US tech companies like Intel and Microsoft dominating the list. Even though that bubble burst, many of the biggest companies of today like Amazon and Google were established in this period. It was more fun to buy Amazon at the bottom in September 2001 at USD 6 per share compared to December 1999 at around USD 100 per share. Still, at the time you would have made good returns buying Amazon at that peak with Amazon now trading around USD 1780 per share, compounding at more than 15% per year since then. The common wisdom at the time was correct. The internet is one of the biggest human inventions of all time with profound consequences for the world including the world of business. You connect the entire world by a web so that ideas from everywhere can meet and prosper. It was a recipe for growth and it provided an arena that created giants as well as many losers. As a platform economy in the making, it took skill to identify the winning companies, particularly as huge disappointment with most stocks in that era followed, which emphasizes the importance of carefully analyzing the individual shares.

## 2010's

Just after the Great Financial Crisis where the epicenter was the bubble of the US housing market, we find oil and commodity stocks back on top of the list with Exxon being number one in terms of market cap. For the first time in modern history, there were three Chinese stocks with the Chinese banking giant ICBC making the list. After a massive debt increase and very strong growth, China became the world's growth leader post the financial crisis. China's thirst for commodities in the infrastructure and housing boom drove demand of commodity assets and Chinese assets in general. The boom in the demand created again a sharp expansion in the production of raw materials, however the boom in China wasn't sustainable for commodity companies and the Chinese banks. Ten years later, a significant rotation had occurred among the largest companies in the world.

## 2020's

Now at the start of the 2020's, the US again takes up 8 of the 10 positions on the list of the world's biggest companies – and Microsoft are together with Apple and Amazon in the top 5. We are in the platform economy and software and service apps dominate the top ten list. The two Chinese internet giants Tencent and Alibaba complete the picture of a world economy dominated by the US and China. The fact that China is the most populous country in the world, coupled with all the changes happening there, increases the chance that common perception is right, and that China and the US will dominate the world economy in the 2020's. We continue to believe that the massive transition, where companies shift IT infrastructure to the cloud makes Microsoft and Amazon likely contenders for the top ten list of 2030; and that Microsoft actually makes the top ten list for the fourth decade in a row.

## 2030's

It's common to assume, that the dominant companies of today also will be the dominant ones in the future. The shift to the cloud benefitting software companies and giant platform companies that are able to manage local and global political tensions well will probably take-up the space on the 2030 top ten list. Both US and Chinese companies are likely candidates. The real surprise could be a European platform company. But history also shows that we can expect major paradigm shifts to come.

One of the biggest waves that we have seen in financial markets is the shift towards more sustainable investing and a sustainable lifestyle. The worry about the climate has been a part of life since the dawn of time. The issue has accelerated and in a connected world, the 'saving the planet' wave is gathering strength across the world. The driver is fear – a very powerful force. Looking out into 2030, we would not be surprised to see next generation alternative energy companies – and probably one of the stocks in the unicorn index being part of the list. Two of the keys is a transition to alternative energy/better energy storage and planting more trees! The energy transformation will happen fast, and markets will be even quicker to discount the potential. As an interesting fact, NASA has published that, based on satellite pictures covering the world, the world has never been greener. Compared to 20 years ago, the planet's green leaf area has increased by 5%. That is an increase of 2 million square miles – equal to the size of the Amazon rainforest. China and India account for a third of the greening, but they make up only 9% of the land area. We would not be surprised to see an Indian company on the list in 2030. This land of eternal promises is probably in the process of finally realizing that enormous potential. Political change and the power of the population in a world where ideas are being shared more efficiently than ever before is the opportunity for India.

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The focus here is on the big shifts in conventional thinking that happen – with the human imagination seemingly knowing no limits. Such thinking often builds over a long period of time – from a crazy idea to what is ultimately perceived as reality or conventional wisdom, like the idea of having negative interest rates for example. At birth, a bumblebee that can't fly is a fact of life. A frog being boiled as it doesn't discover that the water is warming, because it happened slowly. And then the unrealistic becomes reality.

Welcome to an extreme reality, where compounding is dead in big parts of the investment universe. But it is still alive and well in the wonderful public stock markets – in good and bad times.

With the right mindset, philosophy and experience, we think the 2020's will be a great decade for the long-term stock picker. The little extra return that a good picker of sustainable growth can find, will play a relatively much bigger part of the returns in the next 10 years compared to the last decade.

By taking a generational perspective on the stock selection, we ensure that returns and sustainability goes hand in hand. For over three decades we have travelled around the world and have found unique companies with sustainable business models and strong managements. It is this work that is our passion.

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# Active Investments

C WorldWide Asset Management Fondsmaeglerselskab A/S is a focused and independent asset manager. Our objective is to deliver consistent, long term capital growth for clients through active investments in listed equities on global stock exchanges.

Our clients are primarily institutional investors and external distribution channels. Our product range includes discretionary asset management services and commingled fund products.

The combination of a unique investment philosophy based on careful stock picking and long-term global trends coupled with a stable team of experienced portfolio managers, has since 1986 resulted in world-class investment performance.

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